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ECONOMIC INTELLIGENCE WEEKLY

26 March 1975

Overview

The Economic Outlook for 1975 in the Six Major Foreign Developed Countries has worsened since our forecast of last September. While price increases will moderate and current account balances improve, GNP will continue to show its lowest real growth of the postwar period. GNP is likely to fall slightly in the first half and is expected to start expanding in the second half. The projected rise for the whole year is only 0.5%, compared with 1% in 1974 and with the long-term rate of 6.6%. No country is apt to grow more than 1-1/2%; Italy's GNP may well decline.

Leading investment indicators plummeted in the fourth quarter of last year, underscoring our forecast of a decline in private fixed investment in the first half of 1975. New orders for machinery and equipment fell in three of the four countries for which data are available. The steepest drop occurred in Japan, down 24%. Another key indicator, orders for nonresidential construction, fell an average 6%.

Because of the severe recession, inflation is now expected to subside more rapidly than thought last fall. For the six countries as a group, consumer prices will rise an estimated 12%, compared with 16% last year. Only Italy and the United Kingdom will experience accelerated inflation, as a result of continued fat wage settlements and the depreciation of their currencies.

Note: Comments and queries regarding the *Economic Intelligence Weekly* are welcomed. They may be directed to [redacted] the Office of Economic Research, Code 143, Extension 7892.

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The combined current account deficit is expected to fall from $20 billion in 1974 to $9 billion this year. Favorable movements in the terms of trade with non-OECD countries and surging exports to OPEC countries will increase the trade surplus by $14 billion. Despite substantial improvement, Italy and the United Kingdom will still have the largest current account deficits, at $6 billion and $7 billion.

Currency Links with the Dollar have been scuttled in favor of maintaining parities with baskets of currencies by Iran, Saudi Arabia, Qatar, and Kuwait. These four Persian Gulf countries apparently wished to insulate import prices from fluctuations in the dollar. The decisions do not directly affect oil prices, which are quoted in dollars. The rationale for the new arrangement could be applied to oil pricing -- perhaps in September when the oil price freeze ends. (For Official Use Only)

Articles

DEVELOPED COUNTRIES: SHORT-TERM ECONOMIC PROSPECTS

Prospects for economic growth in the six major foreign developed countries -- Canada, France, Italy, Japan, the United Kingdom, and West Germany -- have darkened since our September forecast.

Because we underestimated inventory accumulation in 1974, we now project a slight drop in GNP in the first half of 1975 instead of the 3.2% increase forecast earlier. As the inventory overhang is worked off and the reflationary policies take hold, economic growth should begin to pick up in the second half.

We are now more optimistic about price trends and current account balances because of the weakening of aggregate demand and the fall in commodity prices. We expect the wholesale prices of industrial goods to rise at an annual rate of only 6% in the first half, compared with our earlier forecast of 11%. Our estimate of the rise in consumer prices has also been scaled down. In view of improved terms of trade and prospects for large sales to OPEC countries, we estimate a combined current account deficit of $9 billion in 1975, compared with $20 billion in 1974.

Growth Prospects

We expect that the GNP of these countries as a group probably will increase by only 0.5% in 1975, compared with the long-term average of 6.6%. Near-stagnation in the first half will be followed by the beginnings of recovery in the second. France and Britain will be slightly ahead of the pack, and Italy will bring up the rear.

We expect inventory adjustment to depress 1975 GNP in the six countries by more than 1 percentage point, with nearly all of the impact occurring in the first half. [redacted]

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Although fears of renewed inflation and payments problems probably will rule out drastic shifts in policy, the recession requires that government policy become more stimulative over the course of 1975.

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France has just announced a wide program of mildly expansionary measures, largely tax breaks for business.

Developed Countries: Changes in Real GNP

Percent

	Average Annual 1959-73	1974	Projected 1975	Change from Previous Half Year, at Annual Rate, Seasonally Adjusted			
						Projected	
				1974 I	1974 II	1975 I	1975 II
Total	**6.6**	**1.0**	**0.5**	**-0.2**	**0.6**	**-0.3**	**2.0**
Canada	5.1	3.6	0.2	5.7	-1.7	0.3	2.0
France	5.8	4.3	0.7	5.0	1.7	-1.0	3.3
Italy	5.5	3.6	-0.5	3.0	-0.7	-1.2	0.4
Japan[1]	10.9	-1.7	0.5	-5.5	3.0	-0.6	2.1
United Kingdom	3.3	-0.6	1.0	-2.0	2.7	0.5	0.3
West Germany	4.9	0.4	0.1	2.0	-2.8	0.4	2.4

1. Reflecting preliminary revisions of 1974 data.

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25X6 *Italy* has eased credit restrictions. [redacted] 25X6

With the shift to more expansionary policies, government purchases of goods and services will be the most rapidly growing component of final demand in 1975. By the second half, growth in government purchases will reach an estimated annual rate of 4.4%, the only rate that begins to approach its long-term trend.

Higher real disposable income is the major factor in the expected 2% rise in consumption. Higher real wages will prove the main boost to income while income maintenance programs will help pad the effects of unemployment.

Private fixed investment, down 4.5% last year, probably will be flat in 1975; a continued decline in housing construction should offset a fractional rise in business investment. Excess capacity, lower profits, and uncertainties about final demand will be the major drags on business investment.

Outlook for Inflation

On the plus side, industrial wholesale prices are expected to rise only 7.5%, compared with a breathtaking 26% last year. The inflation of consumer prices also will slow, but less dramatically. Weak overall demand, lower raw material and food prices, and the leveling off of oil prices are the primary factors in the slowdown. Rising unit labor costs will provide the major inflationary stimulus.

Developed Countries: Increases in Consumer Prices

Percent

	Average Annual 1959-73	1974	Projected 1975	Change from Previous Half Year, at Annual Rate, Seasonally Adjusted		Projected	
				1974 I	1974 II	1975 I	1975 II
Total	4.8	15.7	11.8	18.9	14.4	11.6	10.0
Canada	3.4	10.8	11.0	10.3	12.6	10.7	10.0
France	4.7	13.6	10.8	15.0	14.6	10.3	8.2
Italy	4.8	19.3	20.2	19.6	27.9	18.6	16.9
Japan	6.2	24.4	12.8	32.2	17.6	11.9	10.2
United Kingdom	5.1	15.9	18.1	18.9	16.3	21.0	14.5
West Germany	3.5	7.0	5.3	8.6	4.9	5.1	6.1

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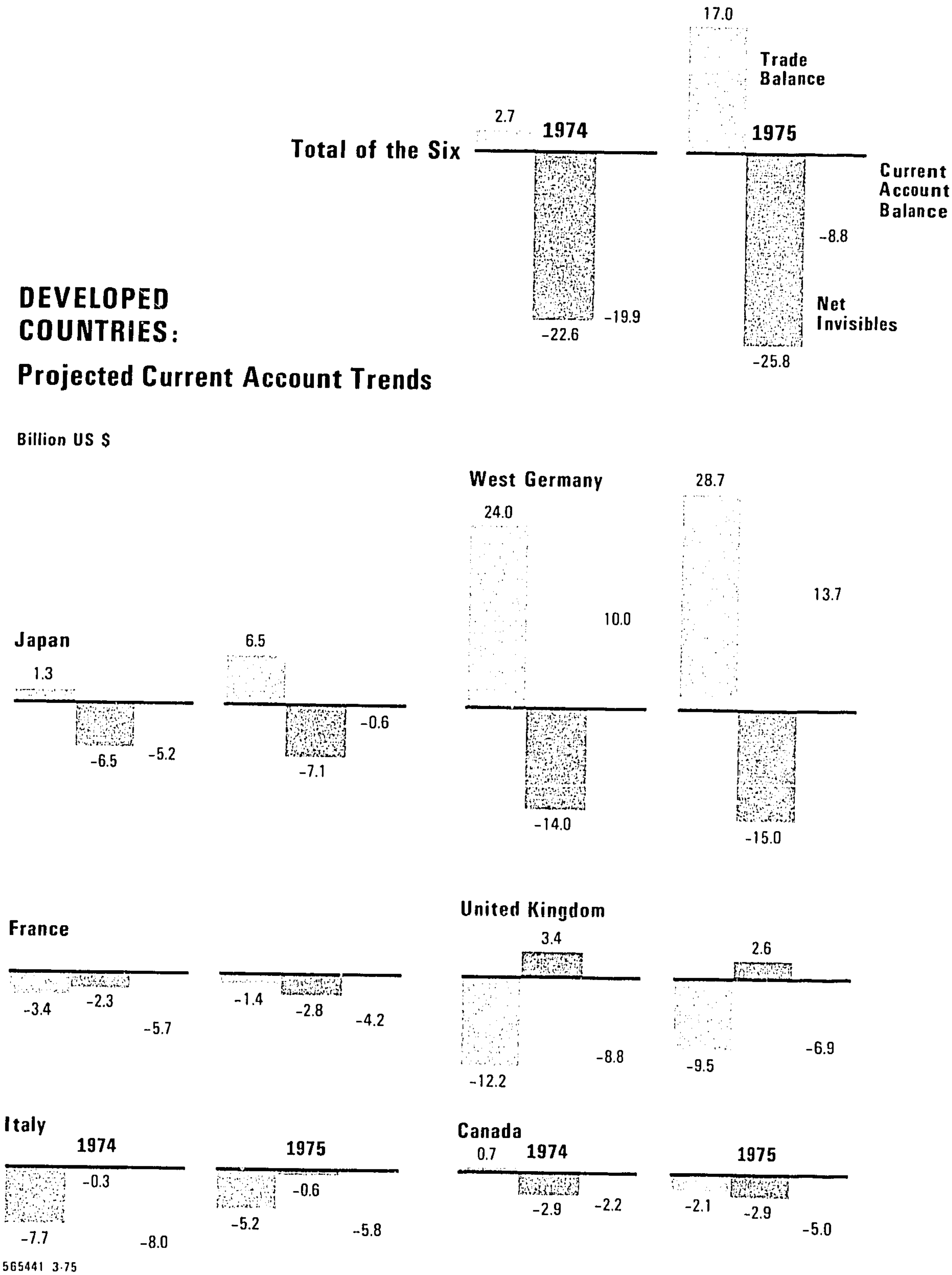
[redacted] Italy, on the other hand, will experience accelerated inflation, resulting from large wage hikes and the depreciation of their currencies since mid-1974.

Trends in the Current Account

The combined current account deficit will fall by an estimated $11 billion this year, to $9 billion. This forecast rests on our expectation of a sharp improvement in terms of trade, particularly in the first half. We believe that the dollar prices of the exports of the six countries will rise 14% and that dollar prices of imports – which are weighted more heavily with oil, food, and raw materials -- will rise only 10%. With production stagnant, little change is anticipated in trade volume, apart from increased exports to OPEC states.

About half of the $14 billion rise anticipated in the trade surplus will stem from trade with OPEC countries; the other half will come predominantly from trade with non-OPEC LDCs. An increase in interest payments resulting from heavy borrowing to pay oil bills will offset perhaps $2 billion of the trade gain.


DEVELOPED COUNTRIES:
Projected Current Account Trends
Billion US $
Total of the Six
1974
2.7
-22.6
-19.9
1975
17.0
Trade Balance
Current Account Balance
-8.8
Net Invisibles
-25.8
Japan
1.3
-6.5
-5.2
6.5
-0.6
-7.1
West Germany
24.0
10.0
-14.0
28.7
13.7
-15.0
France
-3.4
-2.3
-5.7
-1.4
-2.8
-4.2
United Kingdom
3.4
-12.2
-8.8
2.6
-9.5
-6.9
Italy
1974
-0.3
-7.7
-8.0
1975
-0.6
-5.2
-5.8
Canada
0.7
1974
-2.9
-2.2
1975
-2.1
-2.9
-5.0
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West Germany is expected to increase its current account surplus from $10 billion to $14 billion. Even though substantially improved from 1974, the estimated Italian and British deficits of $6 billion and $7 billion will require heavy borrowing of petrodollars.

Comparison with OECD Estimates

Our estimates of economic growth for the full year 1975 are slightly more pessimistic than the estimates of the OECD Secretariat. We foresee a larger drop in inventories in the first half than OECD does, while being more optimistic about government purchases and private fixed investment in the second half. Our projections of price movements are close to the OECD forecasts. Our estimate

Developed Countries[1] : Comparison of CIA and OECD Projections

	Percent Change from Previous Half Year, at Annual Rate, Seasonally Adjusted				Percent Change in 1975	
	1975 I		1975 II			
	CIA	OECD	CIA	OECD	CIA	OECD
Real GNP	-0.3	0.8	2.0	1.8	0.5	1.1
Consumer prices	11.6	11.5	10.0	11.0	11.8	12.5
	Billion US $					
	1975 I		1975 II		1975	
	CIA	OECD	CIA	OECD	CIA	OECD
Current account balance	-4.1	-6.2	-4.7	-5.7	-8.8	-11.9

1. Canada, France, Italy, Japan, the United Kingdom, and West Germany.

of the combined current account deficit is $3 billion lower than the OECD figure -- a small difference, considering the amount of trade and services involved. We anticipate a stronger improvement in terms of trade with OPEC countries and non-oil LDCs and larger sales to the latter nations. (For Official Use Only)■

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CYPRUS: ECONOMIC RECOVERY NOT IN SIGHT

Eight months after the Turks invaded Cyprus, the once-prosperous island is still reeling from the war and the resulting unbalanced disposition of resources. Both the Greek and Turkish sectors face at least another year of economic dislocation, which will further destabilize the political situation.

On the Eve of the Invasion

The Cypriot economy was already under stress before the war. Drought had reduced agricultural output by 20% in 1973 and had helped cut economic growth to only 2%, compared with the hefty 7% average of the previous 10 years. The grain shortage had aggravated inflation and stimulated imports, causing a rare balance-of-payments deficit. Economic strains had worsened in early 1974 under the impact of sharp price increases for oil and other commodities. By midyear, inflation was running at 12% and unemployment was double the usual low level.

Effects of the War

The invasion of July-August 1974 drastically worsened the situation. Although damage to structures was small, half the livestock and much standing timber were destroyed. More than 200,000 persons, out of a population of 660,000, were displaced. The Greek population lost half of its agricultural land, most of its tourist facilities, some iron and copper processing plants, and several large ports. In effect, the bulk of the island's resources was transferred to the Turkish Cypriots.

Situation in the Greek Sector

At yearend, the truncated Greek Cypriot economy still was staggering from the effects of the invasion. Production in the petroleum refining, brewing, bottling, and clothing plants still in Greek hands was down severely from midyear levels. Inflation had accelerated to a 15% annual rate, earnings from tourism and the British bases at Dhekelia and Akrotiri had tumbled, and the unemployment rate remained at roughly 30%. Foreign exchange reserves continued at the island's prewar level only because the contraction and disruption of the economy caused imports to fall even more than exports.

Starting last October, the Greek Cypriot government took its first steps toward rebuilding the economy, including

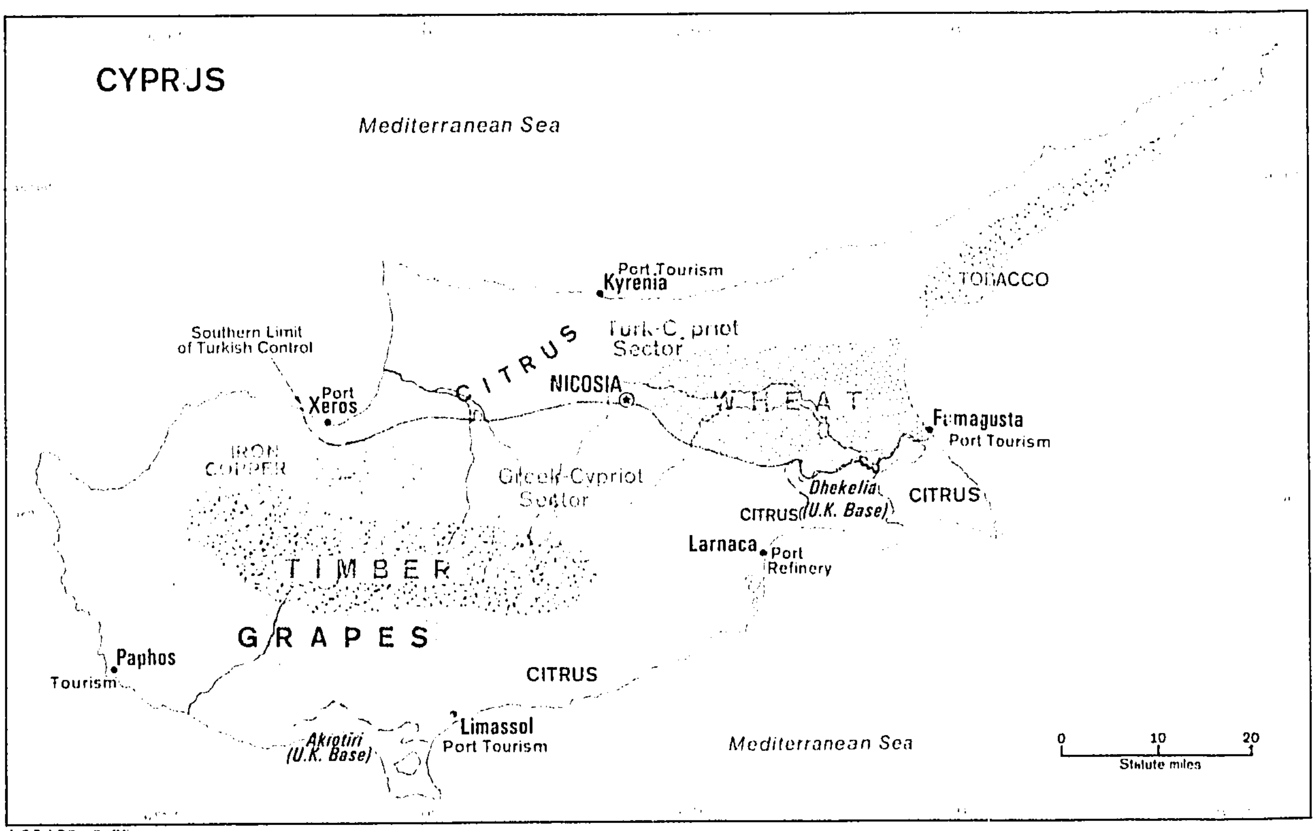
- a 30% deduction from wages and profits to support the refugee relief fund established soon after the invasion;
- temporary restrictions on the dismissal of workers in the private sector;
- earmarking of $4 million in government funds to create jobs; and
- prompt completion of the deepwater port at Limassol, the building of an airport at Larnaca, and the construction of several new roads.

The short-term outlook is grim because the government is constrained by inadequate revenues and an unwillingness to accept the reality of partition. Although reconstruction work, government financial aid for business, and emigration should reduce unemployment by two-thirds this year, at least 20,000 people will remain on the government dole. The sector's budget could go into the red by $250 million in 1975 since reconstruction and relief needs are substantial and Athens is providing little assistance. The financing of such a deficit – twice the deficit of the whole island last year -- practically guarantees that inflation will continue in the two-digit range.

To meet essential needs of consumers and enterprises, the Makarios government will have to dip into Cypriot foriegn reserves, which remain under its control. Import volume will increase as reconstruction proceeds and employment expands. Export volume will remain low because production of citrus fruits – the main export -- has passed into Turkish hands. The area probably will suffer deterioration in terms of trade; prices are generally weakening for its exports of foodstuffs and raw materials. With tourist earnings wiped out and revenues from the British bases down (most dependents have departed), foreign reserves could fall $135 million, or 50%, this year.

Situation in the Turkish Sector

The new Turkish Cypriot state is experiencing economic paralysis despite considerable aid from Turkey. Ankara, which dominates the interim administration of Rauf Denktash, has begun to lay down the institutional prerequisites for growth by developing a five-year plan, making the Turkish lira the common currency, and installing the Turkish Agricultural Bank as the Sector's central bank. Turkish military and civilian engineers already have restored basic services.



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The labor shortage nonetheless has kept most industrial firms from resuming operations. Commercial activity has slipped badly because many former Greek Cypriot businesses have been given to untrained Turkish Cypriot migrants from the south. While the citrus crop has been gathered and marketed, other agricultural activity continues at a depressed level, with many farms still unoccupied.

Little economic expansion is likely this year, because the Turkish Cypriots lack the numbers, skills, and money needed to marshal their resources. Economic problems at home have induced Ankara to reduce its assistance and to offer loans instead of grants. Efforts to attract private Turkish investment are having scant success. Unless Ankara pours in more money and persuades more mainland residents to migrate, recovery promises to be slow. (Unclassified) ■

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IRON ORE EXPORTERS' GROUP POSES LITTLE THREAT

An Association of Iron Ore Exporters will be established at a ministerial-level meeting next week in Geneva. While the organization will have no authority to establish prices or production quotas, most of its LDC members will try to push it in that direction. Their chances of transforming the Association into an effective cartel are slim. Australia, Canada, Sweden, and Brazil -- four prospective members that account for 44% of world iron ore exports – oppose the formation of a cartel.

The objectives of the Association, agreed upon at a preparatory meeting earlier this year in New Delhi, are to

- promote close cooperation among iron ore exporting countries and ensure orderly growth of the export trade in iron ore;
- assist member countries to improve their iron ore export earnings;
- encourage domestic processing of iron ore, including production of iron and steel; and
- provide a forum for the exchange of information.

The Association probably will be based in London, have a permanent board and a secretariat, and arrange periodic ministerial-level meetings. Besides the initial 15 invitees, membership will be open to other nations that export iron ore or hold substantial ore reserves. Observer status apparently will not be permitted. The organization will be financed by equal contributions from member nations.

Share of Prospective Association Members in World Iron Ore Production and Exports

Percent

	Production	Exports
Total	38.8	74.2
LDCs	19.8	39.4
Brazil	5.3	9.1
India	4.2	6.9
Liberia	2.8	6.3
Venezuela	2.4	5.4
Peru	1.6	2.8
Chile	1.1	2.8
Mauritania	1.1	2.8
Algeria	0.4	0.9
Swaziland	0.4	0.9
Philippines	0.2	0.6
Sierra Leone	0.2	0.6
Tunisia	0.1	0.3
Developed countries	19.0	34.8
Australia	9.3	16.8
Canada	5.4	9.5
Sweden	4.3	8.5

Earlier efforts by India, Algeria, and Venezuela to set up a producers' cartel failed, largely because of the opposition of Australia and, less vocally, of Canada and Sweden. Indeed, Australia and Canada have not yet made a final decision to join the Association. Brazil, the largest LDC iron ore exporter, has been investing heavily in order to expand iron ore exports 60% by the end of the decade. It consequently does not want to be constrained by production quotas. The other 11 LDC members do not have much market power, since they account for only 14% of iron ore output and 30% of iron ore exports.

If a change of heart by the leading exporters did transform the Association into an operating cartel, iron ore importing nations would be vulnerable. The massive volume of imported iron ore (300 million tons annually) and the lack of substitutes or reserve stocks would give importers no short-term alternative to paying higher prices. The United States imports about 35% of its iron ore requirements; Western Europe, 40%; and Japan, 98%. (Confidential)■

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INDONESIA: IMPACT OF THE OIL BONANZA

Under the umbrella of OPEC prices, Indonesia has just turned in its best two years of growth. National output in this economy, debt-racked and stagnant as recently as the mid-1960s, grew 8%-10% in both 1973 and 1974. Continued rapid expansion in exports and agricultural output should yield solid gains for the rest of the decade even without substantial new commitments of concessionary aid from the United States, Japan, and Western Europe.

The 1973-74 Surge

The Suharto regime rearranged national policies and debt schedules so as to achieve an average 7% growth for 1967-72; the more recent acceleration was caused by increased oil revenues and recovery from drought. The $4 billion rise in oil earnings in 1973-74 came from the dramatic price boosts, an increase in the government's contractural share of oil revenues, and a 29% jump in output. The augmented oil revenues supported stepped-up spending on development projects, salary increases for government workers, the enlargement of national food stocks, greater imports of consumer and producer goods, and a buildup of foreign exchange reserves by $1 billion.

Current Outlook

Indonesia will achieve real growth of about 7% in 1975, despite the global recession. Increased imports of machinery and raw materials will promote rapid growth in agriculture, manufacturing, and the service sectors. Although exports will probably not grow, inflows of aid and private capital point to another sizable surplus in international accounts.

Economic Prospects for the Rest of the Decade

As the industrial world recovers from recession in 1976, Indonesian exports should again begin to grow at a rate adequate to permit sustained national growth of 7%-9%. Assuming an increase in oil prices of 12%-14% for 1976-78, we estimate that oil and natural gas revenues should nearly double by 1978. The implied production increases are clearly within Indonesia's reach in terms of resources. The Indonesians have adopted policies encouraging the oil companies to push production vigorously. The Suharto government would probably break out of the OPEC cartel rather than accept a prorationing scheme that cost them substantial development gains.

The Indonesians will continue their efforts to develop other sectors. Increased use of high-yield rice varieties, chemicals, irrigation, and new techniques should support a growth rate of 4%-5% in farming. Manufacturing will probably grow about 10% annually, faster than in any comparable period in Indonesian history. Both foreign and domestic investment should rise rapidly in processed foods, metal fabrication, finished lumber, and chemicals.

Beyond 1978 the course of Indonesian growth will depend heavily on the international oil market. If prices remain unchanged in this period, Indonesia will probably be able to sustain the 1976-78 performance, meet its scheduled debt payments, and end the decade with ample foreign exchange reserves. This path would not require concessionary aid commitments beyond those already made, although it would entail official borrowing on near-commercial terms on the order of $300 million annually.

Per capita income will be about $200-$225 in 1980, compared with the current $150. Continuing high levels of unemployment in Djakarta will provide the seedbed for social unrest, with students and other groups bringing intermittent pressure on the government. Transportation and communications problems will continue to vex this farflung and fragmented economy and inhibit the development of national markets. (Confidential)■

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Notes

World Coffee Prices Decline Further

The world coffee market has continued to weaken as (a) recession curtails consumption, (b) importers reduce their inventories, (c) negotiations to revive the International Coffee Agreement drag on, and (d) attempts at collusion among the exporting countries remain ineffective. Prices have fallen about 25% from the highs of last summer. Among the hardest hit by falling prices are the Central American countries, which have sold heavily in recent months. These countries apparently have not made use of Venezuela's plan to help them finance the withholding of coffee from the market, probably because the loans offered cover only about half the costs involved and call for short-term repayment. Prices should turn up in the near future, since importer stocks are now very low and increased buying cannot be put off much longer. (Unclassified)

EC to Modify Beef Import Restrictions

The EC probably will soon replace its current restrictions on beef imports with a "pairing" system under which dealers must match beef imports with the same quantity of exports. Since July, imports have been limited to the GATT-bound quota of 36,000 tons annually. The new quota will be 100,000 tons. Because excess supplies in world beef markets will make expansion of exports difficult, this ceiling is unlikely to be reached. The pairing system will be used mainly to satisfy import demand for specialty meats. (Confidential)

Publications of Interest

China: Agricultural Performance in 1974
(ER IM 75-4, March 1975, Confidential No Foreign Dissem)

This memorandum reviews 1974 agricultural production in China, discusses grain imports, and evaluates 1974 in the light of the long-term program for self-sufficiency.

The World Sugar Market: Situation in 1974 and Outlook for 1975
(ER IR 75-6, March 1975, Confidential)

This report describes how world sugar prices skyrocketed in 1974 because of a combination of strong demand, lagging supplies, and pessimistic reports on the 1974/75 crop By early March 1975, speculation had cooled and the deepening world recession had cut prices to less than 30 cents a pound from a high of 65 cents in November. These forces combined with good crop prospects for 1975/76 probably should maintain downward pressure on prices throughout 1975. Prices still will be high by previous standards.

Communist Aid and Trade Activities in Less Developed Countries, February 1975
(ER RP 75-10, March 1975, Secret No Foreign Dissem)

This month's publication features new developments in Communist economic and military aid programs in African, Near Eastern, and South Asian countries. Topics include Chinese interest in Third World oil technology and recent developments in Soviet military aid to India.

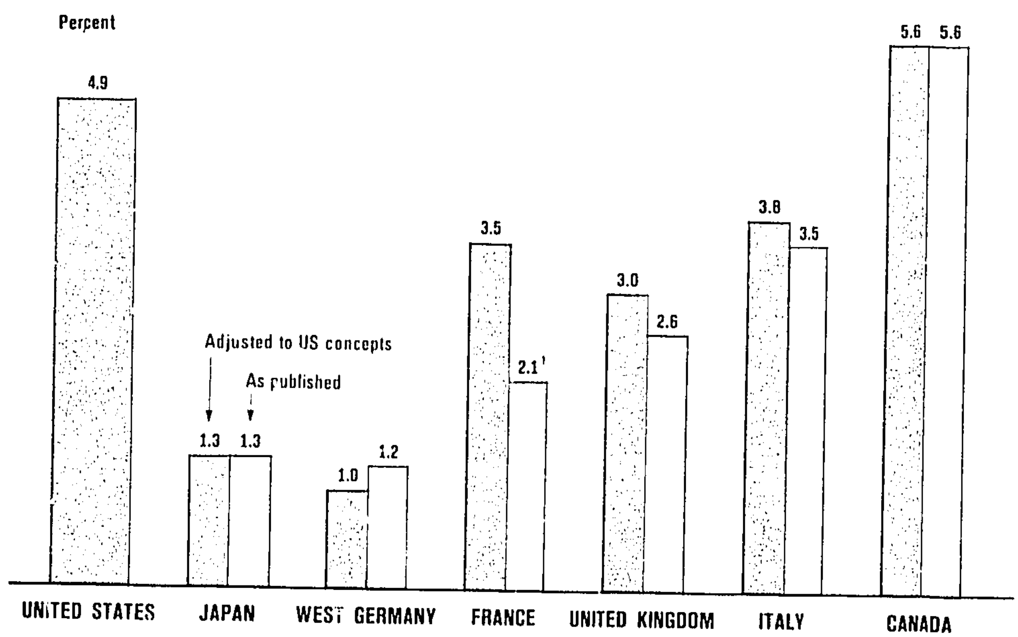
Technical Note

Unemployment Data in the EIW Statistical Section

Unemployment data from foreign official publications and press releases vary from US data in concept and coverage. The US Bureau of Labor Statistics occasionally publishes foreign unemployment data adjusted to US concepts, but BLS warns that the adjusted figures are only approximately comparable. The adjustment factors included in the note to the EIW unemployment chart (Page A-2) are based on BLS results for 1973.

There are substantial differences in the way both labor force and unemployment estimates are derived in various countries. Differing assumptions and methods are used in extrapolating population from census benchmark data, in estimating participation rates, and in estimating the number unemployed from registration or survey data. The use of adjustment factors can itself be a problem. For example, a factor derived from a period when reported unemployment was very low may be subject to a substantial margin of error if used to adjust data

Comparative Unemployment Rates, 1973



[1] Estimated

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for years of high unemployment. Although comparison of unemployment rates between countries may involve a large margin of error, changes in the number unemployed and in the unemployment rate for any one country are fairly reliable indicators of the state of the economy. As indicators they are sometimes lagging, sometimes coincident. (Unclassified)

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